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8 UNITED STATES DISTRICT COURT
9 CENTRAL DISTRICT OF CALIFORNIA
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11	SECURITIES AND EXCHANGE)	CASE NO. CV 11-5316-R
12	COMMISSION,)	
13	Plaintiff,)	ORDER GRANTING DEFENDANT'S
14	vs.)	MOTION <i>IN LIMINE</i> TO EXCLUDE
15	PETER L. JENSEN and THOMAS C.)	PROFESSOR HAYN'S EXPERT
16	TEKULVE, JR.,)	TESTIMONY, PLAINTIFF'S MOTION
17	Defendants.)	<i>IN LIMINE</i> TO EXCLUDE PROFESSOR
)	BEAVER'S EXPERT TESTIMONY, AND
)	DEFENDANT'S MOTION <i>IN LIMINE</i>
)	TO EXCLUDE ANY REFERENCE TO
)	NINE MILLION DOLLARS IN PROCEEDS

18 **I. Background**

19 Plaintiff Securities and Exchange Commission ("Plaintiff" or the "SEC") alleges that
20 Defendants engaged in a two-year fraudulent scheme to materially inflate the revenues of Basin
21 Water, and that Basin's CEO, Defendant Peter Jensen ("Defendant"), made over nine million
22 dollars profit by selling Basin shares based on inside information regarding Basin's true financial
23 condition. The SEC's expert, Professor Carla Hayn, conducted an event study that purportedly
24 reflects the effect that an August 11, 2008 press release – indicating Basin may have to restate
25 certain financial statements as a result of revenue recognition issues – had on the value of Basin's
26 stock price.

27 Defendant submitted expert testimony from Professor William Beaver who purportedly
28 calculated what Defendant would have profited if Basin's true financial condition was revealed in

1 the first instance, without any need for the press release and subsequent restatement. To do so,
2 Professor Beaver utilized a regression analysis that he opines is far more accurate than a standard
3 event study, even though it has not attained the same level of general acceptance within the
4 scientific community. Further, he opines it is altogether inappropriate to use an event study under
5 the circumstances of this case.

6 The SEC filed a Motion *In Limine* to exclude Professor Beaver's opinions, arguing they do
7 not meet the requirements of Federal Rule of Evidence 702 for three reasons. First, they do not
8 meet the threshold for introduction of expert testimony because they do not help the trier of fact
9 understand the evidence or to determine a fact in issue. Second, these opinions are not the product
10 of reliable methods or principles. Third, Professor Beaver has not reliably applied the principles
11 and methods he uses to the facts of this case.

12 Defendant filed a competing Motion *In Limine* to exclude Professor Hayn's opinions
13 concerning her event study under Rule 702, arguing that an event study cannot be accurately
14 applied to the facts of this case. Further, even if an event study could be utilized here, Professor
15 Hayn failed to properly conduct the event study. Defendant also filed a separate Motion *In Limine*
16 to prohibit the SEC from referencing Defendant's alleged nine million dollar profits. Defendant
17 contends, as evidenced by the opinions of both experts, the nine million dollar figure does not
18 reflect the effect of Defendant's alleged misrepresentations and is therefore irrelevant or at least
19 unduly prejudicial.

20 Notably, Defendant also moved to exclude Professor Hayn's price earnings ratio analysis,
21 which was offered in rebuttal to Professor Beaver's report. However, the SEC voluntarily
22 withdrew that portion of Professor Hayn's rebuttal opinions. Professor Hayn also offered opinions
23 relating to whether the various transactions at issue in this case were correctly accounted for,
24 which are not a subject of the *Daubert* motions under consideration by the Court.

25 As discussed below, both experts' opinions must be excluded as the Court finds that they do
26 not assist the trier of fact and otherwise create a danger of confusing the issues, misleading the
27 jury, causing undue delay, and wasting time. Thus, the parties' cross motions to exclude each
28 other's experts' opinions are granted for those reasons. Defendant's motion concerning any

reference to nine million dollars is also granted because that figure is arguably irrelevant, and the probative value of any reference thereto is substantially outweighed by its prejudicial effect.

II. Legal Standard

A. Federal Rule of Evidence 702

Federal Rule of Evidence 702 provides that expert testimony is admissible if "scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue." Fed. R. Evid. 702. Expert testimony under Rule 702 must be both relevant and reliable. *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 589 (1993). When considering evidence proffered under Rule 702, the trial court must act as a "gatekeeper" by making a preliminary determination that the expert's proposed testimony is reliable. *Elsayed Mukhtar v. Cal. State Univ., Hayward*, 299 F.3d 1053, 1063 (9th Cir. 2002), *amended by* 319 F.3d 1073 (9th Cir. 2003). "This entails a preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid and of whether that reasoning or methodology can be applied to the facts in issue." *Daubert*, 509 U.S. at 579. The trial court must determine that the experts based their conclusions on scientific methods and procedures rather than mere subjective beliefs or unsupported speculation. These preliminary questions must be established by a preponderance of the proof. *Id.* Yet, the trial court must scrutinize an expert's reasoning and methods without inquiring into the soundness of the expert's conclusions. *Claar v. Burlington N. R.R. Co.*, 29 F.3d 499, 501 (9th Cir. 1994).

As a guide for assessing the scientific validity of expert testimony, the Supreme Court provided a non-exhaustive list of factors that courts may consider: (1) whether the theory or technique is generally accepted within a relevant scientific community, (2) whether the theory or technique has been subjected to peer review and publication, (3) the known or potential rate of error, and (4) whether the theory or technique can be tested. *Daubert*, 509 U.S. at 593-94. The Ninth Circuit also has indicated that independent research, rather than research conducted for the purposes of litigation, carries with it the indicia of reliability. *See Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 43 F.3d 1311, 1317 (9th Cir. 1995) ("*Daubert II*"). In particular, using independent, pre-existing research "provides objective proof that the research comports with the

dictates of good science" and is less likely "to have been biased by the promise of remuneration."
Id. If the testimony is not based on "pre-litigation" research or if the expert's research has not been
 subjected to peer review, then the expert must explain precisely how he went about reaching his
 conclusions and point to some objective source – a learned treatise, the policy statement of a
 professional association, a published article in a reputable scientific journal or the like, to show
 that he has followed the scientific method, as it is practiced by (at least) a recognized minority of
 scientists in his field. *Id.* at 1318-19 (citing *United States v. Rincon*, 28 F.3d 921, 924 (9th Cir.
 1994)); *see also Lust v. Merrell Dow Pharmaceuticals, Inc.*, 89 F.3d 594, 597 (9th Cir. 1996).
 The proponent of the evidence must prove its admissibility by a preponderance of proof. *See*
Daubert, 509 U.S. at 593 n. 10.

The list of factors for determining reliability are not exclusive because the test is flexible to
 fit the subject matter. *Id.* at 141, 150, and 153. "[N]othing in either *Daubert* or the Federal Rules
 of Evidence requires a district court to admit opinion evidence which is connected to existing data
 only by the *ipse dixit* of the expert." *G.E., Inc. v. Joiner*, 522 U.S. 136, 146 (1997).
 Nonetheless, expert testimony is liberally admitted under the Federal Rules. *Daubert*, 509 U.S. at
 588, (noting that Rule 702 is part of the "liberal thrust of the Federal Rules and their general
 approach of relaxing the traditional barriers to opinion testimony") (internal quotations omitted).
 The trial court must be careful to avoid supplanting the adversary system or the role of the jury:
 "[v]igorous cross-examination, presentation of contrary evidence, and careful instruction on the
 burden of proof are the traditional and appropriate means of attacking shaky but admissible
 evidence." *Id.* at 596; *see also* Fed. R. Evid. 702 advisory committee notes to 2000 amendments
 ("[R]ejection of expert testimony is the exception rather than the rule.").

B. Federal Rule of Evidence 403

Federal Rule of Evidence 403 provides that evidence, although relevant, may be excluded
 "if its probative value is substantially outweighed by a danger of . . . unfair prejudice, confusing
 the issues, misleading the jury, undue delay, waste of time, or needlessly presenting cumulative
 evidence." Fed. R. Evid. 403. This is a balancing test left to the sound discretion of the trial court.
See, e.g., Maddox v. Los Angeles, 792 F.2d 1408, 1417-18 (9th Cir. 1986).

1 In determining whether to exclude evidence under Rule 403, the court should consider the
 2 probative value of the evidence and should evaluate the relative weight of these factors as to the
 3 evidence in question as well as to actually available substitute evidence, stipulations, etc. If there
 4 is alternative evidence with substantially the same or greater probative value as the proffered
 5 evidence but with a lower danger of unfair prejudice, exercise of a sound judicial discretion would
 6 discount the value of the proffered item and exclude the proffered evidence if its discounted
 7 probative value were substantially outweighed by unfairly prejudicial risk. Such a weighing
 8 should be made in view of the availability of other facts appropriate to the Rule 403 determination
 9 as well as with an appreciation of the offering party's need for "evidentiary richness and narrative
 10 integrity in presenting a case" *Old Chief v. United States*, 519 U.S. 172, 182-83 (9th Cir.
 11 1997) (citing, *inter alia*, the advisory committee notes to Rule 403).

12 **III. The Expert's Opinions Are Inadmissible at Trial Under Federal Rules of** 13 **Evidence 702 and 403**

14 As a threshold matter, an expert witness must possess "sufficient specialized knowledge to
 15 assist the jurors in deciding the particular issues in the case." *Kumho Tire Co. v. Carmichael*, 526
 16 U.S. 137, 156 (1999) (citation omitted). The proponent of the witness bears the burden of
 17 establishing an expert's helpfulness. Here, the Court finds that neither Professor Hayn's event
 18 study nor Professor Beaver's regression analysis is helpful to the jury in understanding the
 19 evidence or in determining a fact in issue. Further, the opinions' probative values are substantially
 20 outweighed by a danger of confusing the issues, misleading the jury, causing undue delay, and
 21 wasting time. These opinions, however, will be admissible at the damages phase of this action.

22 **A. Summary of Professor Hayn's Event Study**

23 "An event study is a statistical regression analysis that examines the effect of an event on a
 24 dependent variable, such as a corporation's stock price." *In re Imperial Credit Indus. Sec. Litig.*,
 25 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003) (internal citations and quotations omitted). "While
 26 event study techniques have become more sophisticated over the years, their basic format and
 27 methodology have not materially changed." *Bricklayers & Trowel Trades Int'l Pension Fund v.*
 28 *Credit Suisse First Boston*, 853 F. Supp. 2d 181, 186 (D. Mass. 2012) (discussing a conventional

1 securities fraud event study). Professor Hayn utilized an event study to measure the magnitude of
2 the price drop in Basin stock associated with the August 11, 2008 press release. Briefly, Professor
3 Hayn concluded that the August 11, 2008 press release decreased the value of Basin's stock at
4 least 35%, approximately 3.5 million dollars.

5 **B. Summary of Professor Beaver's Response Coefficient Analysis**

6 Unlike event study methodology, Professor Beaver's method is not as widely accepted in
7 the scientific community, and Defendant could not provide any cases discussing its application.
8 Nonetheless, Professor Beaver purports to have estimated the value of the portion of Defendant's
9 stock sales that are attributable to the difference between the restated results for the transactions at
10 issue and those originally reported. To do so, he applied earning response coefficients derived
11 from five statistical models to three different scenarios. The statistical models measure the
12 relation between companies' earnings and their stock prices; four of the models were obtained
13 from academic literature published prior to the filing of this case and the fifth was developed from
14 Professor Beaver's study of firms comparable to Basin Water. The three scenarios reflect
15 different combinations of alleged misrepresentations for which Defendant may be found liable.
16 Application of the coefficients to each scenario produced estimates of stock price inflation ranging
17 from \$20,622 to \$1,143,678. Professor Beaver opined that the median of these estimates,
18 \$411,106, is the most reasonable reflection of what the additional value in Basin Water stock
19 would have been had the restated results been reported originally, because the median accounts for
20 all of the factors reflected in each of the five statistical models.

21 **C. The Experts' Opinions Should Be Excluded Under Federal Rule of**
22 **Evidence 702**

23 The Court finds that the experts' opinions will not assist the trier of fact and are not a good
24 fit for the issues to be presented at trial. An event study is an accepted method of measuring the
25 impact of alleged securities fraud on a stock price and often plays a "pivotal" role in proving loss
26 causation and damages in a securities fraud case. *In re Williams Sec. Litig.*, 496 F. Supp. 2d 1195,
27 1272 (N.D. Okla. 2007). Likewise, Professor Beaver's methods are – apparently – typically used
28 to estimate damages in shareholder litigation; indeed, the only article identified by Defendant that

1 discusses Professor Beaver's method argues that estimates of financial fraud damages obtained
2 through the use of response coefficients are superior to event studies. *See* Esther Bruegger and
3 Frederick C. Dunbar, *Estimating Financial Fraud Damages with Response Coefficients*, 35 Iowa
4 J. Corp. L. 11, 12 (2009).

5 However, the SEC, unlike a private plaintiff, need not demonstrate reliance and loss
6 causation. *See SEC v. Leslie*, 2010 U.S. Dist. LEXIS 76826 at *93 (N.D. Cal. July 29, 2010).
7 Instead, the SEC claims it is offering Professor Hayn's opinions as evidence of materiality and
8 motive. But the SEC contradicts its own position by arguing that Professor Beaver's opinions
9 should be excluded because they only relate to the amount of disgorgement of Defendant's ill-
10 gotten gains and the amount of reimbursement of profits – two issues to be determined by the
11 Court at the remedies stage of this case, not by the jury at the liability stage. Highlighting the
12 SEC's conflicting positions, Defendant argues that Professor Beaver's opinions must be admitted
13 to challenge the SEC's theory of motive by showing that the alleged inflation was relatively
14 minimal and thus hardly a reason to commit securities fraud.

15 The Court finds, however, that expert testimony is not required to show that the stock price
16 drop is probative of materiality in this case. “[I]f the Government wishes to use a stock price drop
17 as evidence of materiality, it must demonstrate that public disclosure of the misstatements charged
18 in the indictment had an appreciable negative effect on the stock price.” *United States v. Schiff*,
19 538 F. Supp. 2d 818, 835 (D.N.J. 2008) (internal citation omitted). There is no dispute that the
20 August 11, 2008 press release had an appreciable negative effect on Basin's stock price; even
21 Professor Beaver admits that, if the information had been properly disclosed in the first place,
22 without any need for a restatement, there would have been an appreciable negative effect on the
23 stock price in the amount of \$411,106. Expert analysis is not required to draw an inference that
24 after-the-fact admissions of accounting errors have a greater, negative impact on stock price than
25 the impact of accurate financial statements. Granted, expert testimony may be required to
26 establish that a stock price drop is linked to the alleged misconduct in cases where there are
27 multiple factors, such as confounding disclosures, potentially contributing to the drop. *See, e.g.,*
28 *Schiff*, at 837. But the Court finds that assessing the materiality of the confounding factors in this

1 case, if any, does not require scientific, technical, or other specialized knowledge. *Cf. United*
 2 *States v. Ferguson*, 2007 U.S. Dist. LEXIS 93355, 6-7 (D. Conn. Dec. 20, 2007) (admitting lay
 3 opinion testimony from analysts regarding whether their valuation of the company would have
 4 been different if they had known about the allegedly misstated loss reserves). Therefore, evidence
 5 of the stock price drop may be admitted without requiring expert analysis.

6 **D. The Experts' Opinions Should Be Excluded Under Federal Rule of**
 7 **Evidence 403**

8 The Court also recognizes that measuring the exact amount of the stock inflation may have
 9 some probative value as to Defendant's motive or a lack thereof. But the probative value of such
 10 evidence is substantially outweighed by the danger of confusing the issues, misleading the jury,
 11 undue delay, and wasting time. *See* Fed. R. Evid. 403. Both parties have alternate evidence
 12 bearing on Defendant's motive; namely, there are genuine disputes in this case concerning
 13 whether any accounting violations were committed negligently or intentionally and both parties
 14 will be presenting expert evidence in support of their respective theories. Thus, the Court finds
 15 that excluding these expert opinions from trial will not interfere with either party's need for
 16 evidentiary richness and narrative in presenting the case.

17 **E. The Experts' Opinions Will Be Admissible in the Remedies Phase**

18 Although the Court concludes that the experts' opinions will not assist the trier of fact at
 19 the liability stage, they will assist the Court at the remedies phase. The experts' opinions relate to
 20 two issues concerning remedies – the amount of disgorgement of Jensen's ill-gotten gains as a
 21 result of his fraudulent insider trading, and the amount of reimbursement of profits realized by
 22 Jensen's securities sales that must be reimbursed under Sarbanes Oxley Act, Section 304.

23 The SEC contends that Proessor Beaver's method is unreliable because it has not appeared
 24 in any case law and has only been cited and reviewed by inapplicable sources. However, at the
 25 *Daubert* hearing, Professor Beaver identified an article published in 2009 that discusses the
 26 benefits of his method, especially compared to an event study. *See generally* Dunbar, *supra*, 35
 27 Iowa J. Corp. L. 11. Professor Beaver also identified several experts who have defended this
 28 method at deposition or otherwise. Further, in addition to pointing to an article in a reputable

1 journal, Professor Beaver methodically explained “precisely how he went about reaching his
2 conclusions.” *Daubert II*, 43 F.3d at 1318-19 (internal citations omitted). Although the SEC
3 contends that law review articles are typically not subject to peer review, “shaky but admissible
4 evidence is to be attacked by cross examination, contrary evidence, and attention to the burden of
5 proof, not exclusion.” *Primiano v. Cook*, 598 F.3d 558, 564 (9th Cir. 2010) (citing *Daubert*, 509
6 U.S. at 596)). Thus, the Court finds that Defendant has proved the admissibility of Professor
7 Beaver’s opinions by a preponderance of proof for the purpose of assessing remedies. *See*
8 *Daubert*, 509 U.S. at 593 n. 10.

9 Concerning Professor Hayn’s event study, Defendant contends that it is not a reliable
10 method for measuring remedies in this case. However, even the article cited by Defendant – that
11 is critical of event studies – acknowledges that they are generally accepted by both the academic
12 community and the courts as a reliable principle or method for determining whether a particular
13 announcement by a company has caused the price of the company’s stock to decline:

14 Event studies are widely used in litigation to measure the effect of
15 alleged misconduct by examining the share price impact of relevant
16 disclosures. The event study method is commonly used in securities
17 litigation for estimating the share price impact of events because it
18 meets scientific standards. These standards include the following: it
19 provides testable results that may be replicated by other analysts; it
20 is supported by published literature; it produces estimates with a
21 known rate of statistical error; and it has generally been accepted by
22 the scientific community.

23 Dunbar, 35 Iowa J. Corp. L. at 16 (internal citations omitted).

24 Still, Defendant asks the Court to engage in what have been “heated disputes among
25 experts over what was meant by proper application of the method.” *Id.* at 13. Specifically,
26 Defendant points out that the information in the press release indicated a need to restate multiple
27 past financial statements, but the event study does not attempt to isolate inflation per share, before
28 the various accounting violations had accumulated. Defendant also contends that an event study
cannot account for confounding information that would have a negative impact on the stock price.
Finally, Defendant contends that Professor Hayn improperly utilized a three day event window
instead of a one day event window.


1 Notably, Professor Hayn contends she considered all of the information in the press release
 2 but her interpretation is that all of the negative information is related to the restatement. And
 3 Defendant did not cite any case law expressly limiting an event study to a one day window and the
 4 article he relies on in admitting his own expert's opinions supports the use of a three day window.
 5 *See* Dunbar, 35 Iowa J. Corp. L. at 48 ("For causal analysis, academics have converged to using
 6 shorter event windows when estimating ERCs, usually one to three days.").

7 Considering the factors enumerated in *Daubert*, Professor Hayn's event study is
 8 admissible. Defendants have not identified any other authority that definitively mandates its
 9 exclusion. Thus, these opinions will be admissible at the damages phase of this matter.

10 **F. Defendant's Motion *In Limine* to Exclude Any Reference to Nine Million**
 11 **Dollars**

12 Defendant argues the SEC should be prohibited from referencing his alleged nine million
 13 dollar profits because, as evidenced by the opinions of both experts, the nine million dollar figure
 14 does not reflect the effect of Defendant's alleged misrepresentations. The Court agrees. Thus, any
 15 reference to nine million dollars in profits is prohibited under Federal Rule of Evidence 401 as it is
 16 irrelevant, and under Federal Rule of Evidence 403 as its probative value is outweighed by a
 17 danger of unfair prejudice and confusing the issue of violations of SEC requirements.

18 **IT IS HEREBY ORDERED** that Defendant's Motion *In Limine* to Exclude Professor
 19 Carla Hayn's Expert Opinions, Plaintiff's Motion *In Limine* to Exclude Professor William
 20 Beaver's Expert Opinions, and Defendant's Motion *In Limine* to Exclude All Argument or
 21 Reference to Nine Million Dollars in Proceeds From the Sale of Basin Shares are GRANTED.
 22 Dated: March 13, 2013.

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 25 MANUEL L. REAL
 26 UNITED STATES DISTRICT JUDGE
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